DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 99-0046SLOF
SALES AND USE TAX
For the Tax Years 1995, 1996, and 1997

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ISSUES

I. Applicability of the State's Gross Retail Tax on the Transfer of Catalogs from Taxpayer to Parent Corporation.

Authority: IC 6-2.5-2-1; IC 6-2.5-3-1(b); IC 6-2.5-3-2(a); IC 6-2.5-4-1(b); IC 6-2.5-4-1(c); Cowden & Sons Trucking, Inc. v. Indiana Dept. of Revenue, 575 N.E.2d 718 (Ind. Tax Ct. 1991); Miles Inc. V. Indiana Dept. of Revenue, 659 N.E.2d 1158 (Ind. Tax Ct. 1995).

Taxpayer takes the position that the business arrangement between itself and its parent company is solely for the provision of services, that no transfer of tangible personal property between the taxpayer and the parent company occurs as a result of that arrangement, and that the provision of catalogs to the parent company's customers does not constitute a transfer of tangible personal property subjecting the taxpayer to the state's gross retail tax.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that it is entitled to abatement of the ten-percent negligence penalty and that the Department of Revenue (Department) should exercise its discretion to do so.

STATEMENT OF FACTS

Taxpayer prepares, prints, and distributes catalogs on behalf of the parent company and is located outside the state. Parent company is in the catalog retailing business. A sales tax audit for 1995, 1996, and 1997 was conducted resulting in modifications to the taxpayer's sales tax liability for all years under the audit. The audit determined that the transactions between taxpayer and parent company, evidenced by the transfer of catalogs, constituted retail transactions and were subject to sales tax.

The taxpayer disagreed with the audit's determination on the ground that the activities performed in acquiring and distributing the catalogs were exclusively those of a service provider. Taxpayer was granted a hearing to discuss the issues and a Letter of Findings was issued subsequent to the hearing. The Letter of Findings found that the taxpayer was engaged in retail transactions and was subject to sales tax on payments received for those catalogs which were mailed to parent company's potential customers located in Indiana or delivered to taxpayer's distribution center before being shipped to recipients located both within and outside of Indiana. In addition, the Letter of Findings found that the taxpayer was subject to the ten-percent negligence penalty.

Taxpayer argues that the determinations contained within the Letter of Findings were wholly without merit and requested the opportunity for a rehearing on the identical issues. That request was granted, a rehearing was conducted, and this Supplemental Letter of Findings revisits the issues.

DISCUSSION

I. Applicability of the State's Gross Retail Tax on the Transfer of Catalogs from Taxpayer to Parent Corporation.

Indiana's gross retail (sales tax) is imposed on "retail transactions" conducted within the state. IC 6-2.5-2-1. Retail transactions are defined as "selling at retail." Id. IC 6-2.5-4-1(b, c) defines "selling at retail," stating that:

> A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he: (1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration.
>
> (c) For purposes of determining what constitutes selling at retail, it does not matter whether; (1) the property is transferred in the same form as when it was acquired; (2) the property is transferred alone or in conjunction with other property or services; or (3) the property is transferred conditionally or otherwise.

The taxpayer has entered into an arrangement with parent company whereby taxpayer is responsible for the production and delivery of the parent company's retail catalogs. By the terms of their agreement, taxpayer is made responsible for the selection and supervision of the advertising companies and printers necessary to produce the catalogs. Taxpayer is also made responsible for the distribution of the catalogs to bulk mailing centers or the parent company's distribution center. Under the terms of the agreement, taxpayer is required to "take title" to the catalogs at the time they are delivered and does not transfer title to the parent company.

By the terms of their agreement, the parties agreed that the title to the catalogs would always remain with taxpayer and that the agreement was exclusively one for the provision of the services rendered in the production of the catalog. Specially, the agreement states that, "Except as expressly provided in this Agreement, neither [parent company] nor [taxpayer] authorizes the transfer, use, consumption, control or right of use of the title or possession, whether actual or constructive, of tangible personal property in any manner or form pursuant to this Agreement. Tangible personal property owned or controlled by [parent company] or [taxpayer] shall, at all times, remain in the sole control and possession of respectively, [parent company] or [taxpayer]. *This agreement provides the provision of services only, except as expressly provided herein.* (Emphasis added).

In effect, the parties' agreement explicitly sets forth terms in which taxpayer produces catalogs intended for the use of parent company's customers, provides for the distribution of the catalogs to the parent company's existing and potential customers, but provides that ownership of the catalog remains with taxpayer until the catalogs were actually delivered to the ultimate recipients.

The taxpayer argues that the decision reached by the tax court in Cowden & Sons Trucking, Inc. v. Indiana Dept. of Revenue, 575 N.E.2d 718 (Ind. Tax Ct. 1991) is supportive of its contention that it never intended to transfer ownership of the catalogs to the parent company and that, as a result, it was not responsible for collecting sales tax. In Cowden a trucking company, having engaged in certain transactions in which it transported stone, was assessed sales tax on the value of the transportation services. The Department argued that the service costs were taxable because Cowden had entered into a unitary transaction which included hauling services and the sale of stone. The court disagreed, finding that the sale of the stone was not inextricable and indivisible from the transportation services. The court stated that the issue should be resolved by discerning Cowden's intent and that evidence supported Cowden's "assertion that the acquisition of stone was for the convenience and accommodation of its customers, incidental to its hauling services and not for the purposes of resale." Id. at 721. The court found that the sale of the stone was one transaction and the provision of the services was a second, severable transaction and that the second transaction was not subject to the sales tax. Id. at 722. The court found relevant the fact Cowden did not maintain an inventory of stone to sell to its customers, did not advertise the sale of stone, did not hold itself out as a stone merchant, and that 95 percent of the taxpayer's customers engaged Cowden exclusively for its hauling services. Id. at 721. In addition, Cowden – because it merely charged its customers for the cost of the stone – had no profit motive in selling stone to its customers and that transfer of stone was entirely incidental to Cowden's provision of transportation services. Id. at 721-22.

Taxpayer sets out a second argument based upon the tax court's decision in Miles Inc. V. Indiana Dept. of Revenue, 659 N.E.2d 1158 (Ind. Tax Ct. 1995). In that case, Miles was assessed use tax on certain promotional materials temporarily stored at an Indiana location. The court held that Miles was not subject to the use tax finding that the storage of the promotional materials at Miles' Indiana warehouse facility and the withdrawal of those materials for subsequent shipment outside of Indiana did not constitute a taxable "use" but fell under the storage exception contained in IC 6-2.5-3-1(b). Id. at 1164 Taxpayer's argues that it was not required to assess sales tax because the catalogs were temporarily stored in Indiana for shipment to the ultimate out-of-state recipients of the catalogs. Taxpayer maintains that its position is reinforced by the Department's own published rulings.

Finally, taxpayer makes a more general equitable argument on the ground that the Department is unreasonably attempting to increase the taxpayer's sales tax liability over and above the liability it would have incurred had the taxpayer not restructured its business relationship with the parent company. According to the taxpayer, if the Department had not assessed the additional sales tax, it would have paid use taxes – based on the tangible personal property used to produce the catalogs – equal to the amount it would have owed previous to the restructuring. Therefore, according to taxpayer, the assessment of sales tax is inherently inequitable.

The taxpayer asks the Department to agree that taxpayer is in the business of providing services, agree that the parent company is merely a disinterested purchaser of those services, and agree that taxpayer is in the "business" of providing catalogs to the parent company's customers. The taxpayer asks too much of the Department. The relevant statutory language is clear and straightforward. Sales tax is assessed on the transfer of tangible personal property in the course of the taxpayer's regularly conducted trade or business when that property is transferred for consideration. IC 6-2.5-4-1(b). For the purpose of determining that applicability of the sales tax, it is irrelevant whether the property is transferred alone or in conjunction with other services. IC 6-2.5-4-1(c). Taxpayer is in the business of preparing and printing catalogs. Parent company is in the business of selling items which are available in those catalogs. Parent company is interested in having the catalogs in the hands of its potential customers. Parent company and taxpayer entered into a relationship in which taxpayer would exercise its specific abilities, prepare the catalogs, and then arrange to have the catalogs delivered. Parent company agreed to pay taxpayer for the cost of the catalogs together with a "mark-up" of five percent not to exceed $250,000. The finer points of the parties' agreement to the contrary, taxpayer is transferring tangible personal property for a consideration and is responsible for collecting sales tax on the transaction. The parties' attempt to circumscribe their agreement as one for the "provision of services only" is illusionary because the centrality of the agreement was for the provision of catalogs. Parent company wanted catalogs, taxpayer printed catalogs, parent company paid taxpayer, taxpayer owes sales tax.

Taxpayer relies on <u>Cowden</u> to support the proposition that services may be provided to a customer in which the transfer of tangible personal property is entirely incidental to the provision of the services. Taxpayer is correct. The court found that Cowden was in the business of providing transportation services. Cowden owned equipment for the provision of those services and did not maintain an inventory of stone. Cowden did not advertise for the sale of stone and did not hold itself out as a stone merchant. Ninety-five percent of Cowden's customers sought out Cowden for its hauling services. On occasion, Cowden purchased stone on behalf of its customers "merely for the convenience of its . . . customers." <u>Cowden</u> at 721. In taxpayer's case, it is clearly and exclusively in the business of producing catalogs destined to be placed in the hands of the parent company's customers. The provision of the catalogs is not ancillary or incidental to the taxpayers' business and is not made for the occasional convenience of the parent company. The singular objective of the parties' agreement is that catalogs – by themselves useless to the taxpayer – are placed in the hands of the parent company's customers for the benefit of the parent company.

Taxpayer's reliance on <u>Miles</u> is equally unavailing. In that case, the tax court determined that the taxpayer was not required to pay use tax on promotional materials that were stored in Indiana for subsequent use outside the state. Under the relevant statute, the use tax is imposed on the "storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction . . ." IC 6-2.5-3-2(a). An exception is provided for that property which is stored in Indiana but which is subsequently used solely outside of Indiana. IC 6-2.5-3-1(b). Taxpayer claims that the catalogs it ships to parent company's Indiana distribution center for eventual delivery to out-of-state customers should be exempted from the *sales tax* based on the *use tax* temporary storage exception found in IC 6-2.5-3-1(b). Even viewed most generously, taxpayer presents a strained argument. There is simply no temporary storage sales tax exemption. If and when the parent company is assessed use tax liability, the parent company would conceivably be entitled to claim the temporary storage use tax exemption. Until that day arrives, the Department must decline taxpayer's invitation to infer a temporary storage sales tax exemption.

Taxpayer's final argument is based on general equitable principles. Taxpayer maintains that the intervening restructuring of its business relationship with the parent company should not be seized upon by the Department as an opportunity to increase taxpayer's sales tax liability. According to taxpayer, had the Department not assessed sales tax, it would have been liable for use tax in an amount equal to the use tax liability it bore previous to the restructuring. Taxpayer is a sophisticated business entity free to enter into any business arrangement which it deems appropriate. Similarly, taxpayer is fully capable of comprehending the nature of that business arrangement and understanding the tax consequences which may result. The taxpayer would quite justifiably have protested a determination of its tax liabilities based on the taxpayer's previous business arrangement when that determination would have increased the tax liability over and above what the taxpayer would incurred under its existing business arrangement. The Department is not – nor should it be – placed in a position of enforcing the state's tax laws based on what business arrangement the taxpayer might have, could have, or should have entered into.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer has requested that the ten-percent negligence penalty, imposed under authority of IC 6-8.1-10-2.1(a), be abated. The penalty was assessed against taxpayer's cumulative gross retail tax liabilities determined for the tax years 1995 through 1997.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer."

Negligence results from a “taxpayer’s carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations.” Id.

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax due was due to “reasonable cause.” 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by “demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . .” Id. In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Regardless of the Department’s determination that taxpayer was responsible for paying sales tax on the transfer of catalogs to its parent company, taxpayer has established that its initial failure to collect the sales tax was due to “reasonable cause and not due to willful negligence . . . .” 45 IAC 15-11-2(c). However attenuated its statutory interpretation may have been, it cannot be said that the taxpayer failed to exercise a degree of “ordinary business care.” 45 IAC 15-11-2(c).

FINDING

Taxpayer’s protest is sustained.

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